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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BY HAND

August 2, 2002

Marlene Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

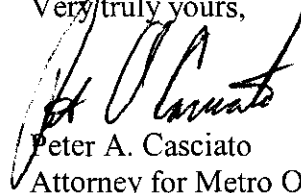
Re: Ex Parte Presentation, CC Consolidated Docket
Nos. 99-273, 92-105 and 92-237

Dear Ms. Dortch:

On August 2, 2002, Tim Timmons, President of Metro One Telecommunications, Nathan Baker, Vice-President of Metro One and Metro One's attorney, Peter A. Casciato made a presentation to James Schlichting, Barry Ohlson, Jared Carlson, Patrick Forster, Rose Crellin and Jennifer Salhus of the Policy Division of the Wireless Telecommunications Bureau. A written copy of the presentation was previously filed with the Commission on July 10, 2002 as part of a previous ex parte filing and is incorporated by this reference. Addressed at the meeting were issues raised in the above-captioned dockets relating to wireless network access to innovative directory assistance service offerings. Other attachments provided at this meeting are attached hereto. In addition, the undersigned met briefly today with Greg Cooke of the Wireline Competition Bureau to further discuss the points made in the previously filed attachment.

Should you have any questions concerning this matter, please contact the undersigned.

Very truly yours,



Peter A. Casciato
Attorney for Metro One
Telecommunications, Inc.

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Enclosures

Talk, Talk, Talk

So who needs streaming video on a phone? The killer app for 3G may turn out to be—surprise—voice calls.

ANDREW ODLYZKO

DIRECTOR, DIGITAL TECHNOLOGY CENTER, UNIVERSITY OF MINNESOTA; FORMER AT&T RESEARCH SCIENTIST

Those third-generation services, combining Internet and wireless technologies, were to ring in a new era of communications. Instead, rising skepticism about their prospects, together with the staggering sums paid by carriers in spectrum auctions, helped precipitate the telecom crash.

But the story may have an accidentally happy ending. The unanticipated killer application of 3G is likely to be voice, the killer app of first- and second-generation systems. This will please both investors and those eager to see effective competition to the local phone monopolies.

3G was sold by its promoters as a way to provide mobile Internet access. But the market has figured out that not only will streaming video not be feasible with 3G, it is doubtful whether it would bring in much revenue even if it could be offered.

People don't want to be entertained by their cell phones. They want to be connected. Note the success of simple text messaging and the failure of content-providing Wireless Access Protocol. The good news is that 3G's higher bandwidth can be used to make room for more calls and maybe make those connections more reliable.

But wait—wasn't the industry hoping to expand beyond what was seen as a nearly saturated market for voice? True, when over 70% of the population has cell phones (as in Finland today, and probably in the U.S. in a couple of years), subscriber growth will slow. However, penetration ratios ignore intensity of usage. Fact is, we've hardly begun to talk.

This may seem surprising, given how often we see people using cell phones in public. However, in the U.S. the total volume of wired voice calls is still more than six times as high as

that of mobile calls. This explains why cell phones are still far from providing effective competition for wired phones.

And yet Americans use their cell phones more than most foreigners: more than 8 minutes per day, versus less than 5 minutes in Britain, for example. This lead stems from AT&T's introduction in 1998 of block pricing (in which, say, subscribers pay a flat fee for 500 minutes of use in a given month). Such offerings doubled the average daily minutes of use in the U.S. between 1997 and 2000. In contrast, Europe's usage per subscriber is declining.

This is where 3G's enhanced bandwidth comes in. Although operators can boost the capacity of current 2G systems even without new spectrum by building more cell towers, these are infamously hard to get approved and ultimately expensive. The investments being made in 3G may not be necessary, as 2.5G would have been sufficient, but they will provide much greater voice capacity.

After all the billions invested, the industry naturally is leery of price erosion. Instead it should be aiming to stimulate a quantum change in customer behavior. If prices go down by half, but usage quadruples, your revenue doubles. U.S. carriers may fret that their price per minute is down by half in the last four years, yet minutes of use are up just enough to keep average monthly bills flat. Contrast Britain, where revenue per retail user was down 20% over the past year.

The essential point is that breakthrough pricing strategies, such as block deals, are needed to bring about the kind of changed social con-

vention that transforms an industry. One logical extension would be toll-free numbers for wireless customer contacts.

The biggest gains, though, are to come from encouraging more nonbusiness use. In a fascinating book, *America Calling*, Claude Fischer showed that the phone industry entered a new high-growth phase in the 1920s when it abandoned the attitude that phones were for important commercial purposes only and instead started encouraging "frivolous" social uses. These served to make telephones an indispensable part of people's lives, and raised usage (and total spending) far beyond the levels envisaged by the industry's pioneers.

However much we might be annoyed by cell phone chatter, the great hope for telco investors is to keep those phones ringing. **F**



*Do you want to transform an industry?
You need breakthrough pricing strategies.*

The giant local phone companies appear to have escaped unscathed in the telecom crackup. Look again: They may well become the final pillar to crumb

BY SCOTT W

Bad C



67%

The average annual growth in the number of American households with landline telephones over the last ten years.

1.7 million

The number of cable companies that are not yet available for local phone service.

WALL STREET HAS A PERVERSE NAME FOR THE BABY BELLS. THEY ARE "COCKROACHES." AN ASTEROID HAS DESTROYED THE whole long-distance and fiber-optic sectors, but somehow the local service providers have survived. Verizon, SBC and BellSouth made a combined \$20 billion of profit last year and have a collective market value of \$240 billion.

So far the Bells' stamina on Wall Street has been remarkable. The stock prices of Verizon, SBC Communications and BellSouth have fallen on average 30% in two years, easily beating the overall market and trouncing Sprint, Qwest, Level 3 and WorldCom, whose shares are off anywhere from 70% to 100%. Investors sought refuge in what had long been one of the most predictable and reliable businesses on the planet. Local phone service has grown, in good years and bad, for seven decades.

Let the shareholder beware: These telecom behemoths are nowhere near as healthy as they appear. While they aren't about to become extinct, neither are they the cash machines they seem to be. Most of those glorious profits are being poured into maintaining equipment or upgrading to meet new competitive threats. In the five years from 1998 through 2002 the Bells will have sunk \$140 billion into capital expenses in their local, long-distance, data and international markets. This monstrous outlay will bring them annual revenue growth in those same areas of 2.5%, barely ahead of inflation. Philip Jacobson, an analyst with Network Conceptions in Vienna, Va., puts it succinctly: "The Bells have shown the ability to invest a lot of money with very little result."

Even as the Bells stand triumphant, the 20th-century foundations of their business have begun to fracture. The Baby Bells could one day be exposed as the last great telecom illusion, undone by a combination of an overwhelming wave of new competition—from cable, wireless, resellers and elsewhere—and their own underwhelming success at diversifying into new services such as Internet access. They are on a capital-spending treadmill, and the treadmill is picking up speed.

Competition and price-cutting that first struck the long-distance business and then cell phone service are now spreading to local service. The Bells' phenomenal strength is rooted in their absolute lock on the nation's 180 million local phone lines and the seeming inevitability that, each year, they will continue to lay still more. But last year the total number of local phone lines declined

nnnection

1933

The last year, prior to 2001, that the number of local phone lines in the U.S. shrank—in the depths of the Great Depression.

9 million

The net number of local phone lines cut off in 2001.

20 million

Bell's own lines are being cut by competitors, while cable providers...

4.7% from the year before as customers cut off 9 million more lines than they added, according to the Federal Communications Commission. Since AT&T was founded in 1885, government statisticians have recorded a drop in phone lines only once before, during the Great Depression.

The line decline in 2001 was a direct result of the ferocious assault on the Bells from all sides. As many as 3 million customers decided to forgo a home phone last year, going wireless instead. Cable operators are beginning to offer local phone calls on their rebuilt lines, and poached 600,000 Bell customers last year. Another 2 million households canceled the second phone lines they were using for poky dial-up access to the Internet; high-speed cable access and DSL don't interfere with regular phone service, making second lines superfluous. BellSouth workers used to go into new suburbs in the Southeast and confidently bury thick bundles of wires containing 1.5 to 2.5 phone lines for every home in the neighborhood; this year its workers began burying just one phone line for every home its wires pass.

The erosion began to show up last month in BellSouth's second-quarter report, as sales fell 3.5% and earnings plunged 67% on one-time charges, sending the stock down 18% in a day. Verizon and SBC were also expected to report further phone line losses.

It gets worse. The Bells now lease 20 million lines to resellers, up 32% last year, and they're forced to rent out these precious tendrils at regulated prices that are often just two-fifths what they get from consumer accounts. Competitors leasing those lines can exploit weaknesses in the Bells' kooky pricing structures, relics of their days as regulated monopolies, to steal the most profitable customers. The Bells count on 95%-plus operating margins on newer features such as caller ID and voice mail to juice their earnings, since basic monthly fees remain regulated. MCI's new Neighborhood Complete plan offers unlimited local and long-distance calling for \$50 or \$60, depending on the region, with caller ID, call waiting and voice mail—so valuable to the Bells—thrown in free

of charge. Since launching the plan in April MCI has landed 600,000 customers and is signing up 200,000 more each month.

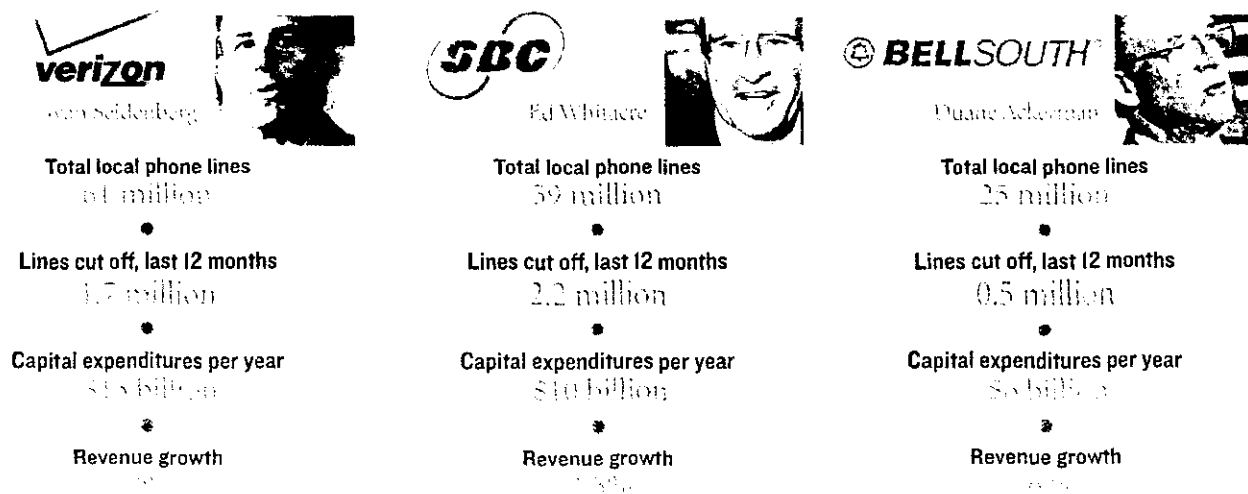
The Bells will have a hard time holding off the panoply of new competitors, says David Dorman, recently named chief executive of AT&T and a former chief of Pacific Bell. As newcomers steal the fattest customers, the Bells will get stuck serving the low-spending, high-cost ones. "Inexorably," he says, "cable and wireless are going to eat into their share."

For six years the Bells have been bracing for this onslaught, steeled by the passage of telecom deregulation in 1996 and eager to counterattack by moving into long distance and Internet access. But their foray has been expensive, and the new-growth markets have proven disappointing. The Bells fought hard for the right to sell long-distance service, something they were banned from doing in the 1984 antitrust breakup of AT&T. It has been a Pyrrhic victory. As of April Verizon and SBC (the only Bells to have won the right to sell long distance in their home states) handled long-distance calls for 13.5 million customers, almost double the total of 18 months ago. Yet their long-distance revenue in that same period declined. In the most recent quarter it was \$1.5 billion, off 6% in a year and a half (see chart, p. 88).

Verizon is the most extreme case of a Bell burning through all its cash just to stay even. By the end of this year the company will have piled up five-year spending of \$75 billion sprucing up the networks of its myriad pieces (the former Bell Atlantic, Nynex and GTE). Its revenue will have grown 5% a year in this time, to \$68 billion this year, with all of that growth due to an influx of new cellular customers. (Verizon owns 55% of Verizon Wireless and consolidates the subsidiary on its own financial statements.) With all that cash plowed into capital projects, Verizon was reduced to issuing new debt to fund \$17 billion in dividend payments. Verizon now creaks under \$61 billion in total debt, including the money owned by Wireless. Moody's recently put Verizon on credit watch for possible downgrade from its current A1 rating.



TELE-TROUBLE As millions cut home phone service, Bell executives have spent billions looking for new growth. They're still looking.



Capital expenditures and revenue growth are averages based on wireline businesses over the last five years. Sources: Company reports, Morgan Stanley.

The other major Bells' stories are only slightly better. In the five years between 1998 and the close of this year BellSouth will have put \$28 billion into capital expenditures. In return the new investment has let the company increase revenue by 6% a year. SBC will have pumped \$52 billion into its core business, to achieve some 2.5% annual growth.

Frederic Salerno, vice chairman of Verizon, counters that the last few years "were a bubble in capital spending... an aberration," forced by the long-distance push and federal rules that required the company to crack open its network and welcome in competitors. Verizon cut capital spending by 45% to \$2.4 billion in the first quarter, though Salerno says it continues to invest in new growth areas. "The loss of access lines is not necessarily a disaster if we are able to

bine local phone service with wireless, long distance and broadband. BellSouth recently introduced the "Complete Choice" plan in the Southeast, bundling local with cell or Internet service. "It reduced churn [turnover of high-speed Internet customers] by nearly 70%," says BellSouth Chief Financial Officer Ron M. Dykes. "As we go forward in telecom, churn becomes probably the most important financial indicator," he adds, which may be why he won't say just what BellSouth's churn is.

Meanwhile, the Bells, attentive to the risk of credit downgrades, are hacking expenses and capital spending. SBC cut 11,000 employees in the past year, 5.5% of its payroll. It also is consolidating 450 call centers into only 180 to save \$700 million annually. Verizon pared 16,000, or 6% of its total, and BellSouth cut 4,500, or 5%.

"INEXORABLY, CABLE AND WIRELESS ARE GOING TO EAT INTO THE BELLS' SHARE."

do two things," he says. "The first is adding new service to the remaining lines; the second is cutting the cost [of those services]."

Bell executives dismiss the idea that they are in trouble. They say soon-to-materialize growth in the newer pursuits—everything from long distance to high-speed Web access to wireless to corporate data-networking—will more than offset any losses in local service. SBC's chief financial officer, Randall Stephenson, argues that stagnating long-distance revenue will begin to flow rapidly as the Bells capture more profitable customers and enter more markets (collectively, they have thus far won approval to sell long distance in 15 of their home states, home to a third of the country's population). He also says the Bells' base of 4 million Internet customers will soon turn profitable as the market shakes off its growing pains. In California, after a customer is hooked up, SBC's operating (a.k.a. EBITDA) margin on digital subscriber line (DSL) service is 40%. "I go out to a mature territory, and I see a business I like," he says.

Analysts on Wall Street often get captivated by EBITDA—earnings before interest, taxes, depreciation and amortization. But wise man Warren Buffett says such talk makes him shudder. One of his letters to shareholders asks acerbically, "Does management think the tooth fairy pays for capital expenditures?" This is the essence of the debate over the Bells' investment value: Defending today's revenue levels may require forever spending so much on new technology that they never have much in the way of free cash flow—what Buffett calls "owner's earnings"—with which to pay down debt or pay dividends. Cable television operators have the same problem (*see story, p. 107*).

Many Bell execs say their biggest weapon against line losses is a growing ability to com-

The Bells can make up for their shrinking core by buying up their beaten-down telecom peers. Rather than continue pouring their cash into their own questionable capital projects, they could try to simply buy growth. Whether to launch a buying binge "is the single biggest strategic issue facing the telecom industry today," says Luiz Carvalho, a wireless industry analyst with Morgan Stanley.

Bankrupt WorldCom has assets on the block at trash-heap prices. Cell phone companies trade for under 20% of their peak market values. VoiceStream, AT&T Wireless, Sprint PCS and Nextel are all cheap enough to fit in a Bell's budget.

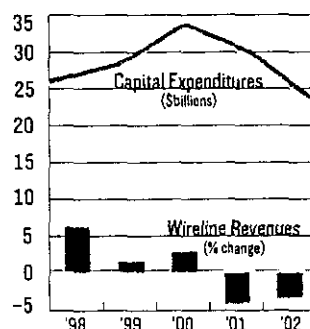
But the window of opportunity won't be open long. "If the Bells screw around for a couple years," warns one top telecom executive, "they won't have the currency." A still bigger problem: Buying wireless or long-distance customers won't get them off the capital spending treadmill.

Verizon Wireless and Cingular (co-owned by BellSouth and SBC) represent the Bells' one reliable source of revenue growth as their core "wireline" businesses have stagnated. Yet the wireless business has proven a sinkhole for investors, who have had to plow ever more money into expanding capacity, with scant return. The average wireless user talked 50% more in 2001 than in 2000, but paid only 5% more for the privilege. With publicly traded wireless stocks off 70% in the past year, Cingular and Verizon Wireless both had to shelve plans to be spun off to the public.

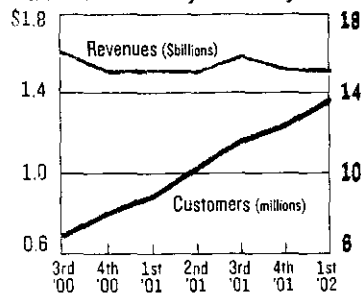
Ultimately, the lure of buying into growth businesses may prove overwhelming, as the Bells struggle to replace the business that their new competitors are stealing. Leap Wireless, a San Diego-based Qualcomm spinoff, has pioneered the sale of cell phone service designed

TELECOM TREADMILLS

Hiking capital spending couldn't halt a slide in revenues ...



... and it takes ever more long-distance customers just to stay even.



Source: Company Reports.

specifically to replace local phone lines. Leap now has 1.4 million customers in 40 midsize cities, and a full 26% of them have cut the cord entirely, canceling local phone service to go wireless. Its subscriber base grew 207% in the past year, and the portion who drop Bell service is rising as well.

Focusing on 40 lesser markets saves Leap the cost of supporting a nationwide network and competing on crowded turf. Its network now costs less than a penny a minute to operate, the company says. (The industry average is roughly 3 cents, according to Morgan Stanley.) The Leap model makes it possible to charge a flat fee—typically \$33 a month—and vastly increase usage. Customers talk on Leap's phones for 20 hours a month, triple the wireless industry average.

It is part of a generational shift to wireless, says Leap's chief executive, Harvey White. "Our demographic is younger, and when people start a household today they simply never bother to get a land line." Leap's business model is being mimicked by half a dozen companies around the country. Qwest offers all-you-can-talk service in Minneapolis and Omaha. Alltel's Boomerang service now serves ten cities, such as Albuquerque and Greensboro, N.C.

Since the Bells own stakes in wireless firms, they get back some of the revenue lost to cord-cutters. But it's a miserable trade. When a Bell customer cuts the

getting into the business of delivering rival video service, but in the mid-1990s those dreams smacked into obstacles of cost and technology. To counter cable in Net access, the Bells pushed DSL, but even that could ultimately hurt their phone business. DSL is a fat enough pipe to let customers shut off primary lines when they add a modem to the household. The idea is simple: Use an Internet connection to carry a phone call from a home out to the regular phone network. Instead of paying the phone company twice for the same wire, pay once for an Internet connection that carries both voice and data. The only hurdle, a significant one, is to make sure an Internet phone provides a prompt dial tone and rings reliably.

Jeffrey Citron, who founded Island ECN and Datek Online, says he has solved those problems. Citron has plowed \$19 million of his own money into Vonage, a company that began offering local service over DSL in April. (It also works with cable modems, cutting the Bells out altogether.) Vonage offers 500 minutes of local and long-distance calling for \$20 a month and unlimited service for \$40. Taking advantage of a technology called Session Initiation Protocol, the phones use the customer's high-speed Internet connection to carry a call to the Internet, which carries it most of the way to its destination before handing it off to the phone network. Island ECN and Datek Online both hit it big by taking



Leap Wireless Chief Harvey White.

"PEOPLE STARTING A HOUSEHOLD TODAY NO LONGER BOTHER TO GET A LAND LINE."

cord to go wireless, the company loses about \$19 in monthly operating income and picks up only \$4 to \$6 or so in return, according to Merrill Lynch. That's because the Bells' wireless arms recapture only a fraction of the cord-cutters, and wireless subscribers generate less cash flow to begin with.

Still worse for the Bells than cord-cutting is losing customers to the cable companies. About 1.7 million Americans now get their phone service over cable lines, a hair under 1% of total phone lines. A tiny number, but one that grew 66% last year. In the few markets where cable has been around for over two years, about 20% to 25% of homes tend to sign up, says AT&T. So far Cox and AT&T have been the only major cable companies to aggressively push local telephone service, but the cost of equipment needed to let a homeowner talk is falling rapidly. Even their more cautious rivals expect to begin avid pursuit of phone customers in the next two years.

The Bells had once hoped to thwart their cable adversaries by

a chunk out of the fat profit margins of Wall Street firms, and Citron sees an opportunity to repeat the feat, this time with the Bells as his target. "The incumbents are ripe for being displaced, and technology has created a naturally disruptive force," he says.

Bell executives dismiss talk of massive erosion in revenue and line growth as scaremongering, and that may comfort the 5.5 million shareholders of Verizon, SBC and BellSouth. But then, similar protestations were lodged by long-distance executives five years ago. Today no one can deny that cellular phones and rampant competition are choking that business to death. Sprint attributed most of its 10% dip in long-distance traffic last quarter to increased cell phone use. AT&T long-distance traffic is expected to drop 25% this year, driven mainly by the relentless advance of wireless. Will local phone service repeat the pattern, becoming the last telecom pillar to crumble?

It's looking mighty wobbly.